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STATEMENT OF

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COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

OF THE

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

ON

THE FEDERAL GOVERNMENT'S EXPERIENCE

WITH FINANCIAL RESCUES

Mr. Chairman and committee members, I am pleased to be here to participate in your deliberations over the formulation of U.S. industrial policy. We have been through a very difficult recession. Unemployment breached the 10 percent mark. Our automobile industry experienced its lowest sales volume in years and the steel industry continues to operate well below capacity. Cities, local governments and States in the northeast and midwest continue to experience difficulties finding ways to pay for the provision of vital services.

BACKGROUND

The Federal Government has assisted individuals, firms and municipalities in hopes of affecting economic behavior and performance for over 100 years through a mixture of macroeconomic, regulatory, procurement, credit and other subsidy, and tax policies. But, since the demise of the depression born Reconstruction Finance Corporation we have not relied on a formal, actively coordinated approach to dealing with the problems affecting our Nation's industrial base, public facilities, or financial system.

In light of our recent economic difficulties, proposals have been made to resurrect the formal approach and some form of a Reconstruction Finance Corporation to implement it. One reason frequently given for this approach is that our many Federal policies work at cross purposes with one another; another is that because many of the foreign industries with which we compete are supported in various ways by their governments, foreign goods enjoy a competitive advantage over ours.

RECENT EXPERIENCE

We have no contemporary experience with a coordinated Federal assistance policy of this sort. Thus, it is very difficult for us to predict how well such a policy might ultimately work, and we are not prepared to take a position on the merits. We do, however, have some limited recent experience with efforts to rescue three large failing firms and one municipality verging on bankruptcy. These were custom tailored responses to isolated financial emergencies rather than sector or industry wide programs.

The Chrysler case is the most recent example. The company received $1.2 billion in loan guarantees and was financially and operationally reorganized. Other cases included the creation of the Consolidated Rail Corporation (Conrail) and the credit assistance provided to Lockheed and New York City.

Conrail was formed in 1974 following the bankruptcy of the Penn Central and other Northeast railroads by the Government's purchase of the assets of the bankrupt railways. It was provided with varying forms of financial assistance totalling about $7 billion.

Lockheed experienced financial difficulties in 1971 because of contractual problems with the Department of Defense and unanticipated costs associated with its reentry into the commercial aircraft business. It received $250 million in loan guarantees to overcome a short-term cash flow crisis.

New York City's rapid growth in municipal employment, a declining tax base and some ill-advised financing and accounting practices led to its being denied access to the municipal bond market in 1975. The City received direct short-term Federal loans of $2.3 billion to overcome cyclical cash flow problems. In 1978 Federal aid to New York City took the form of $1.65 billion in long-term loan guarantees which formed the cornerstone of a new debt restructuring program.

The General Accounting Office has been involved in all of these programs. Based on this experience and our discussions with over 100 individuals who were also involved, we have been developing guidelines for structuring, implementing, and overseeing similar programs that might arise in the future. I would like to spend my time today discussing our findings.

The lessons we have learned are particularly relevant to individual responses to the problems of large failing firms. Some also may be worthy of consideration should the Congress decide to adopt a more formalized approach to addressing the problems facing many of our industries and municipalities.

GUIDELINES FOR FINANCIAL RESCUES

In responding to these situations, it is essential that four conditions be met:

--the problem must be rapidly identified;

--the national interest must be clearly established;

--the goals and objectives associated with the response should be clear and non-conflicting; and

--the Government's financial interests must be adequately protected.

RAPID PROBLEM IDENTIFICATION

When the Federal Government is approached by a troubled firm or municipality, it is essential that the problem be identified quickly. For example, the problems may be largely one firm's, or they may reflect broader industry-wide or regional economic conditions. The problem may be a short-term cash flow deficiency or may be more fundamental. Financial and economic analysis are crucial in identifying the nature of the problem.

In the past, there has been very little time to react to these crises. In light of this, the Government should maintain the capability to rapidly assemble a team of experts to evaluate the situation and propose a course of action. This capability should most logically reside in the Federal Reserve and Treasury Department. In addition, however, the Government may need to draw heavily on other departments and agencies with specialized knowledge of particular industries and on outside experts.

DETERMINATION OF HOW THE NATIONAL INTEREST CAN BE SERVED

If the problems are largely specific to the firm or municipality, it must be decided whether the national interest will best be served through a legislative solution or whether market forces and established judicial procedures should proceed. In reaching the determination, it is essential that all costs of a corporate or municipal collapse be taken into account; not just those borne by the potential recipient.

Careful consideration should be given to a congressionally legislated solution when:

--the potentially large economy-wide or regional consequences of a financial collapse cannot be controlled adequately through bankruptcy, or

--when all costs borne by those affected are potentially larger under bankruptcy than under the legislative course of action.

The Chrysler and New York City situations serve as cases in point.

Chrysler was the tenth largest corporation in the country. It was widely believed that the company could not have been reorganized successfully in a bankruptcy proceeding. In that event its assets would have been liquidated. Virtually every State would have experienced losses of jobs, productive capacity and tax revenues. Analysis indicated that our international trade balance would have suffered as a result of increased market penetration by foreign competitors.

In New York City's case, its buildings would not have disappeared and vital services would have continued. But under bankruptcy the city would have become a ward of the courts, the State or the Federal Government. We suspect that vital services would have been funded largely with Federal dollars. There was also widespread concern at the time that a bankruptcy declaration would severely disrupt the municipal bond market, with unpredictable effects on other cities and States.

In making the national interest determination, the consequences of the bankruptcy alternative must be thoroughly analyzed using sound financial and economic principles.

The same sort of analysis should be used in assessing the financial situation to determine the amount of Federal aid needed, changes that must be made to the firm's or municipality's existing contracts, and the amount of time necessary for recovery. An intimate understanding of the nature of the entity's problems is crucial to the design of the rescue program.

CONGRESSIONAL GOALS AND OBJECTIVES

Once the problem has been identified and the decision made that the benefits of a rescue exceed those of bankruptcy, legislation must be written. It is important that congressional goals and objectives be clear, concise and consistent.

The purpose of an individualized aid program might be

--to assure continuation of a product or service,

--to maintain existing levels of employment,

--to protect those with an economic stake in the entity from disastrous losses, or

--to prevent a broader financial collapse.

It is important to choose clearly among potentially conflicting objectives. For example, was the major intent of the Conrail program to save jobs, or to assure rail service? Several people we have spoken with indicated that for several years this question was unresolved. Without knowing the primary objective, it is difficult to decide what steps are appropriate, and to judge whether a program has succeeded.

Notwithstanding the social costs of unemployment, we question the wisdom of specifying overly rigid employment goals as a primary program objective. The Chrysler program, for example, should in my view be judged a success. Yet the company currently employs about half the workers it did before the loan guarantee program went into effect. Employment based goals are troublesome because pursuing them will often conflict with the cost-cutting actions necessary to return a firm or municipality to long-term self-sufficiency.

PROTECTING THE GOVERNMENT'S INTEREST:

Because these programs have all been custom tailored, and no basis exists to estimate potential losses, it is crucial that the Government's financial interests be protected. This can be achieved in several ways.

1. Concessions From Others

To reduce the Government's risk exposure, help the program appear fair, and create appropriate incentives, the Government should require others with a stake in the outcome to make concessions. The Government should keep in mind, however, that the affected parties will cooperate only if the program offers a better alternative than bankruptcy or liquidation. We should not expect creditors, for example, to make concessions which will cost them more than they expect to lose in a bankruptcy.

2. Controls Over Management

To further reduce the Government's risk exposure, the Government must have the authority to approve an aid recipient's financial and operating plans and new major contracts. To ensure that the Government does not get overly involved in managing the recipient's operations, the Congress should establish criteria for determining which contracts and plans should be reviewed.

When the Government rejects a proposed plan or contract because it is too risky, it should require the firm's or municipality's management to make changes and resubmit the proposal, but the Government should not attempt to develop its own plans and impose them on management. To do so would leave the Government ultimately responsible for the decision.

3. Collateral

The Government should also require, where feasible, that the assisted entity maintain adequate collateral and that all other lenders subordinate their claims on this collateral to the Government's. In some cases, however, collateral may be unobtainable. When this occurs, as it probably would with a municipality, we should seek alternative means of securing the Federal interest.

4. Compensation For Risk

Finally, the Government should receive risk compensation in return for providing Federal aid, particularly if the program succeeds in restoring the assisted entity's financial health. Such compensation is not only desirable in its own right but can create incentives for the recipient to repay the financial assistance as rapidly as possible. Fees should be included, but should not be set at a level representing full risk compensation. Fees at that level would cause too great a cash drain on the borrower. Therefore, other forms of compensation should be obtained, such as equity participation. We believe the use of warrants, as in the Chrysler case, might be appropriate. In deciding how much risk compensation to obtain, the Government should balance the need to create appropriate incentives and the appearance of equity against possibly delaying the assisted firm's or municipality's ability to obtain unassisted access to capital markets.

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I would like to conclude by emphasizing the following points:

1. We can never be certain that a particular rescue program will succeed, but I think the experience in these four cases has taught us how to design those programs in a way that gives us the greatest assurance of success.

2. Some of those lessons are undoubtedly transferable to a more general, institutionalized approach such as a resurrected Reconstruction Finance Corporation. These would include actions to share, control and oversee risk as well as receive compensation for its assumption. But I would caution that there are undoubtedly other factors that should be considered, as well.

3. Finally, what appears to have worked in crisis-oriented, unique situations may be less successful if it becomes routine. It may also have profound effects on the workings of our economy if the management of our cities and businesses comes to assume that rescue is the rule, rather than the exception.

Mr. Chairman, this concludes my prepared statement. I will be happy to respond to any questions you or other committee members might have.